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SUBJECT: KAZAKHSTAN: GOK AND KMG DISCUSS KASHAGAN, OIL AND GAS TRANSPORT ROUTES WITH ENERGY COORDINATOR AMBASSADOR MANN

Classified By: Ambassador John Ordway, Reasons 1.4 (b) and (d)

SUMMARY

¶1. (C) Senior Kazakhstani officials and KazMunaiGaz (KMG) executives told visiting Eurasian Energy Diplomacy Coordinator Ambassador Mann on January 25 that they welcomed the Administration's decision to reestablish the energy coordinator's office. They explained that the GOK pressed to renegotiate Kashagan's terms because rapidly rising project costs were turning the economic balance of the deal against Kazakhstan's interests. They said that all the details of the new Kashagan agreement -- including which companies would be responsible for which operator functions -- would be finalized within four or five months. Mann's Kazakhstani interlocutors recognized the financial benefits of a trans-Caspian oil pipeline, but claimed it would be politically difficult to build one without a five-party agreement on the Caspian's delimitation. Kazakhstan is pressing ahead on plans &9) including its demand to raise tariffs. The Kazakhstaniis explained that building a Bourgas-Alexandroupolis pipeline will not be easy, but reaffirmed that Kazakhstan will provide volume if the project comes to fruition. They were pessimistic about the prospects for a trans-Caspian gas pipeline, citing not only political issues, but a lack of Kazakhstani volume, which raises questions about its economic viability. End Summary.

GOK WELCOMES REVIVAL OF ENERGY COORDINATOR'S OFFICE

¶2. (C) Eurasian Energy Diplomacy Coordinator Ambassador Steven Mann held separate meetings in Astana on January 25 with State Secretary Kanat Saudabayev, Foreign Minister Marat Tazhin, Energy Minister Sauat Mynbayev, KazMunaiGaz (KMG) President Uzakbai Karabalin, and KMG First Vice President Maksat Idenov to discuss developments in Kazakhstan's oil and gas sector. The U.S. Administration, Mann told his interlocutors, had recently decided to revive the coordinator's office. We achieved important successes in the first stage of Caspian oil and gas development -- notably, the Baku-Tbilisi-Ceyhan (BTC) pipeline -- and now sought to enhance cooperation on the second stage, including on trans-Caspian pipelines, Mann explained. Saudabayev reminded Mann that he had personally pressed Washington to recreate the coordinator's office, adding that he hoped the job would not end in 2009 with the new administration. Saudabayev also stressed that Kazakhstan's policy supporting diversification of oil and gas transport routes remained unchanged. Mynbayev

similarly welcomed the renewed USG attention, noting that "we are far from having the market resolve all issues" and thus need diplomatic efforts too. He agreed with Mann on the importance of incorporating more cooperation on energy in the U.S.-Kazakhstan strategic partnership.

KASHAGAN

¶3. (C) Mann told his interlocutors that the USG welcomed the Kashagan deal and appreciated the Kazakhstani side's professionalism in its handling of the negotiations. Mynbayev explained that while the new joint operating structure may not be ideal, the key was that all sides managed to agree to it, and it also provides for more accountability, allowing for better control of expenses. Kazakhstan's position in the negotiations, he stressed, was that it could not consent to a continuation of Eni's role as sole operator and of lesser rights for KMG than for the other partners, especially regarding access to information. KMG is now in a more equal position, though the GOK recognizes that KMG's engineering and technical capabilities are not sufficient for it to play the top role. The issue to be resolved going forward, Mynbayev explained, is how to divide responsibilities in the joint operating company, including which companies will have the operating lead on on-shore, off-shore, pipeline, and drilling activities. The GOK wants the most qualified company selected for each, but will approve whatever ExxonMobil, Shell, and Total decide,

Mynbayev explained. He added that with Kashagan resolved, the GOK expects to increase cooperation with ExxonMobil on other projects. (Note: This is consistent with what we have heard from ExxonMobil representatives. End Note.)

¶4. (C) Echoing Mynbayev's comments, KMG President Karabalin explained that the GOK's original intent was not to change the Kashagan agreement to gain at the expense of the other parties. However, once the GOK learned about the enormous cost increases, it realized it had to do something. With the cost increases, the economic balance of the project had shifted against Kazakhstan's interests, which is why the GOK insisted on restoring that balance. The negotiations, Karabalin contended, were difficult because the companies resisted. At the same time, the GOK recognized that there would be additional costs if the project was delayed further. With a signed MOU, and a budget approved for six months, the parties have four or five months to finalize all the details. KMG has gained a lot from the deal, including a better, stronger image. The other parties also gained from having KMG as an equal partner; where issues arise, KMG can take them immediately and directly to the Prime Minister's cabinet.

¶5. (C) KMG First VP Idenov provided additional details on the GOK's impetus to renegotiate Kashagan's terms. He explained that he had reviewed five key aspects of the project -- decisionmaking; internal controls; health, safety, and environmental standards; technical integrity; and project management -- and determined that Kashagan had failed to meet international standards in each. The consortium tried to blame the Kazakhstanis for everything, but of over 300 consortium staffers, only nine were from KMG, Idenov said. The Kashagan management committee was composed of local representatives of the companies, who did not have proper accountability. The consortium spent \$4 billion on a production island, but the work was not done right. The net present value of the project had dropped by 24.5 percent -- which was fine for Kashagan's well-paid managers, but disastrous for corporate shareholders. Most importantly for Kazakhstan, the cost increases for the overall project (which came at the expense of Kazakhstan's royalties) were staggering, rising from \$8.7 billion to \$57 billion over four years. Nevertheless, the GOK approved all of them -- until the final increase to \$136 billion. Idenov himself proposed the new operating model, compensation for Kazakhstan, and bringing the project in line with international standards.

His principles were to negotiate in good faith, keep the project running during the negotiations, and not use Kazakhstan's new subsoil law amendments.

¶ 6. (C) Idenov said he expects to be chairman of the management committee of Kashagan's new joint operating company, where the leading roles will be played by KMG, ExxonMobil, Shell, and Total. He will insist that the rest of the company's board be made up of the other partners' executive vice presidents, not their local representatives. Eni will continue as the operator for Kashagan's experimental phase only. Idenov would like to find specific tasks for the minority partners, ConocoPhilips and Inpex. Idenov praised KMG's lawyers -- Curtis, Mallet-Prevost -- and its financial advisors -- ABN Amro - for the "superb job" they did in assisting KMG in striking a good deal. He estimated that KMG's compensation, not including KMG's additional equity stake, is worth \$5 billion up front, and \$20 billion over the life of the project.

TRANS-CASPIAN OIL ROUTES

¶ 7. (C) Mann told his Kazakhstani interlocutors that with additional oil from the second phase of TengizChevrOil (TCO) and from Kashagan, Kazakhstan would need to focus more attention on a prospective trans-Caspian oil pipeline. Tankers will be necessary, but probably not sufficient for such volumes. He explained the USG legal position that a five-party agreement on delimitation of the Caspian is not necessary to build a pipeline, and Karabalin added that 6000 kilometers of pipeline have already been laid there. Mynbayev said that the issue is not just a legal one, but rather both legal and political, and that it would difficult to build a pipeline without a five-party agreement. FM Tazhin and KMG President Karabalin separately stressed the same point. Tazhin contended that the 2007 Tehran summit of Caspian littoral states had resulted in a very positive political declaration on delimitation, and there appear to be positive changes in the Russian and Turkmen positions, and maybe even that of Iran. Delimitation would be a key issue

at the 2008 Baku summit, though Tazhin was not optimistic about reaching a final solution for the event. Karabalin added that of course, if a pipeline could be built, it would be very much in Kazakhstan's interests, as it would lower transport costs. Idenov told Mann that he had set up a unit within KMG to develop trans-Caspian pipeline options and had provided \$20 million in funding for its work. Tazhin contended that if the companies put together a "real document" -- something more than a feasibility study -- on a trans-Caspian oil pipeline, it would make discussion of the whole issue "more concrete and productive."

VIRTUAL PIPELINE OF TANKERS

¶ 8. (C) Mynbayev explained that in the absence of a trans-Caspian oil pipeline, Kazakhstan and Azerbaijan would move forward with their own plans for a Kazakhstan Caspian Transportation System (KCTS), including building the appropriate terminal infrastructure in Kuryk and Baku, and developing a "virtual pipeline" of tankers -- Kazakhstan prefers large ones of 60,000 DWT -- to ferry oil from the former to the latter. Mynbayev reminded Mann that when Azerbaijani President Aliyev visited Kazakhstan in August 2007, the two sides had reached an inter-governmental agreement on KCTS, which is currently awaiting ratification. The GOK expects to play a large role in KCTS, but issues that remain to be resolved include dividing functions, getting guarantees from companies to provide supply, and making guarantees to companies on access. Karabalin said that the participation of private companies -- which Azerbaijan wants and Kazakhstan does not -- is another outstanding question. Mynbayev also noted that the Kazakhstani themselves are constructing the Eskene-Kuryk pipeline. It is not a long

pipeline, he stressed, and will be ready in time to handle the supply.

MOVING OIL FROM BAKU ONWARD

¶ 9. (C) Mann asked his interlocutors about Kazakhstan's plans to move oil from Baku onward. Mynbayev noted that the quota for companies in BTC that are shippers of Kazakhstani oil is small, and the long-term plans for the pipeline remain unclear. Karabalin said that BTC will be the number one route for Kashagan oil, but its capacity will likely not be large enough. However, if Azerbaijani oil volumes decline, it may not be feasible to build a second BTC pipeline. This is why Kazakhstan is also looking at the Baku-Supsa pipeline route, and at moving oil through Kulevi and Batumi.

Kazakhstan purchased one-third of the Batumi oil terminal already, and has reached agreement on acquiring 100 percent. Karabalin argued that Azerbaijan wants to charge high prices for Kazakhstani access to BTC. The Kazakhstanis have proposed their being offered the same prices as BTC consortium members. He asked Mann to press the Azerbaijanis to respond to the GOK on this issue. In terms of moving oil from the Black Sea coast onward, Karabalin stressed the importance of KMG's acquisition of Rompetrol, which will enable it to move oil through Constanta and thus avoid the Bosphorus. Rompetrol also has a refinery located just 30 kilometers from Constanta. Both the Batumi and Rompetrol acquisitions allow Kazakhstan to bypass Russia, he noted.

CASPIAN PIPELINE CONSORTIUM (CPC)

¶ 10. (C) Karabalin told Mann that Kazakhstan had agreed to all 10 terms the Russians had placed on CPC expansion. This included the requirement to raise tariffs, even though the Kazakhstanis are not interested in doing this, since the less they pay for transport, the better. (Karabalin noted that just a \$1 per ton tariff increase will raise the costs of exports from Kashagan by \$840 million over the life of the project.) That said, the Kazakhstanis understood the desire of the Russians to make the CPC self-sustaining. Mann advised that he was not optimistic on CPC expansion, noting that whenever problems are resolved, new ones seem to arise.

BOURGAS-ALEXANDROUPOLIS PIPELINE

¶ 11. (C) Mynbayev told Mann that the Bourgas-Alexandroupolis pipeline is "not a simple issue," even for the Greeks. There are major issues to be resolved regarding land acquisition, financing the pipeline, and providing guarantees of access to companies. Diplomatic efforts are needed, not just a reliance on market forces. The pipeline is more important for Russia than Kazakhstan. That all said, the GOK's position is that if the pipeline is built, Kazakhstan will participate, Mynbayev explained. Karabalin said that he expected Bourgas-Alexandroupolis will, in fact, be built. It helps solve the Bosphorus problem, where tankers can bear huge losses --- sometimes up to \$400,000 -- while waiting to go through the straits. KMG and Chevron have committed to provide 10 million tons of crude annually to the pipeline, so long as they get the same terms for access as Russian companies. The Russians, Karabalin explained, are setting up a holding company to build it. Once that is done, the Kazakhstanis will sign a formal agreement on participation.

GAS ISSUES

¶ 12. (C) Ambassador Mann also raised the issue of a trans-Caspian natural gas pipeline, stressing U.S. support for gas westward to Europe. Mynbayev told Mann that this

would be an even more difficult project than an oil pipeline.

On top of the political issues, the economics are doubtful. Without Turkmenistan, the volumes would be very small, and thus such a project would make little sense. Karabalin noted that TengizChevrOil (TCO) could provide significant amounts of gas -- each ton of oil there results in approximately 1 million cm of gas -- but for the foreseeable future, most of that gas will be reinjected. Down the road, gas from TCO could be brought by pipeline to Turkmenistan, to link up with a trans-Caspian gas pipeline. He added that Kazakhstan plans to ultimately provide 15 bcm of gas from Karachaganak to the Orenburg gas reprocessing plant, of which 23 percent would be returned for domestic Kazakhstani needs, and 77 percent sold to Gazprom. The Orenburg expansion project, he said, is moving along fine, though Kazakhstan is not in a rush, as Karachaganak needs to first reach its next output stage.

TENGIZCHEVROIL (TCO) ENVIRONMENTAL FINE

¶13. (C) Mynbayev told Mann that the environmental fine against TengizChevrOil (TCO) was principally an issue for the Ministry of Environmental Protection, as well as for the Ministry of Finance, given TCO's interest in charging the fine against royalties to be paid to the GOK. That said, his Ministry of Energy expected to become more active on the issue.

CHANGES IN TURKMENISTAN

¶14. (C) Tazhin agreed with Mann that there have been positive changes in Turkmenistan, noting, for example, that President Berdimuhamedov had visited the EU in Brussels in November -- something Niyazov would never have done. That said, Tazhin contended that the Turkmen remain unreliable on natural gas, despite the fact that it is their only resource for their country's development. Just several days prior, they had cut off gas exports to Iran, he noted.

KMG RESTRUCTURING

¶15. (C) Idenov gave Ambassador Mann a lengthy, impressive briefing on his ongoing efforts to restructure KMG. Among other things, he aimed to create more individual accountability within the company. Idenov was also working on a detailed code of professional conduct that was consistent with the world's best practices.

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